



Shanghai Pharmaceutical - H

JD.com collaboration has great potential but limited near term impact; Stay N

We are encouraged by SPH's better-than-expected 1Q15 results and have witnessed management's strong commitment to build up shareholder value. SPH's e-commerce venture and its JD.com collaboration have caused investor expectations to move quickly higher and have driven the outperformance of both the A- and H-shares since early March. After revising our model, we derive a new Dec-15 PT of HK\$21.5 for H-shares. However, we believe SPH is still facing a difficult operating environment for its manufacturing business due to tender price cuts and reimbursement control. The contribution from JD.com deal would take a long time to materialize. We are thus N on SPH-H shares.

- JD.com deal.** SPH and JD.com announced a framework for a strategic collaboration. The companies will establish an online sales platform for prescription drugs and offline distribution infrastructure. They will also collaborate on O2O sales of OTC drugs, nutraceuticals, and medical devices/equipment. They will jointly inject capital into an e-commerce JV established as a 70:30 JV between SPH and mgmnt of the JV with SPH contributing Rmb70mn. The JV is expected to be a model for e-commerce of drugs and mobile healthcare. While details of the financial terms are not disclosed, SPH is committed to inject all its DTP drugstore assets into the JV, to provide its extensive distribution and retail network to support the online venture, and retain JD.com as its only exclusive partner for e-commerce of drugs. JD.com will share its database and resources, and inject capital and related resources into JV and will assist in establishment of an online platform and offline distribution, including technologies related to warehouse logistics. The JV will be the exclusive platform for JD.com to be involved in drugs sales.

Neutral

2607.HK, 2607 HK

Price: HK\$23.80

▲ **Price Target: HK\$21.50**
Previous: HK\$18.00

China

Healthcare

Sean Wu ^{AC}

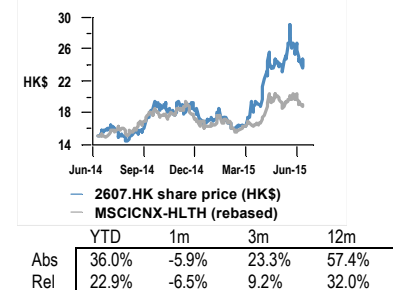
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J.P. Morgan Securities (Asia Pacific) Limited

Price Performance



Shanghai Pharmaceutical - H (Reuters: 2607.HK, Bloomberg: 2607 HK)

Rmb in mn, year-end Dec	FY12A	FY13A	FY14A	FY15E	FY16E
Revenue (Rmb mn)	68,078	78,223	92,399	104,401	116,345
Net Profit (Rmb mn)	2,053	2,214	2,591	2,815	3,080
EPS (Rmb)	0.76	0.82	0.96	1.05	1.15
DPS (Rmb)	0.24	0.26	0.29	0.33	0.36
Revenue growth (%)	24.0%	14.9%	18.1%	13.0%	11.4%
EPS growth (%)	(4.5%)	7.8%	17.1%	8.7%	9.4%
ROCE	8.1%	8.2%	8.9%	9.0%	9.3%
ROE	7.6%	7.8%	8.6%	8.8%	9.1%
P/E (x)	25.0	23.1	19.8	18.2	16.6
P/BV (x)	1.8	1.8	1.7	1.6	1.5
EV/EBITDA (x)	15.9	15.6	13.7	12.6	11.4
Dividend Yield	1.3%	1.4%	1.5%	1.7%	1.9%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data

Shares O/S (mn)	2,689
Market Cap (Rmb mn)	51,230
Market Cap (\$ mn)	8,255
Price (HK\$)	23.80
Date Of Price	11 Jun 15
Free Float(%)	-
3M - Avg daily vol (mn)	6.41
3M - Avg daily val (HK\$ mn)	148.75
3M - Avg daily val (\$ mn)	19.2
MSCI CNX-HLTH	172.19
Exchange Rate	7.75
Fiscal Year End	Dec
Price Target (HK\$)	21.50
Price Target End Date	31-Dec-15

See page 8 for analyst certification and important disclosures, including non-US analyst disclosures.

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Key catalysts for the stock price:	Upside risks to our view:	Downside risks to our view:
<ul style="list-style-type: none"> Corporate restructuring and announcement of LT management incentives Tender wins Major M&A deals Quarterly results 	<ul style="list-style-type: none"> Tender wins in major provinces of key products with lower than expected price cuts Corporate restructuring yields unexpected incentives for management to perform and deliver. Well received M&A 	<ul style="list-style-type: none"> A slower pace of acquisition of new distributors A faster pick-up in sales volume of EDL drugs, resulting in lower margins for both distribution and manufacturing Acquisitions becoming prohibitively expensive

Key financial metrics	FY13	FY14A	FY15E	FY16E
Revenues (LC)	78,223	92,399	104,401	116,345
Revenue growth (%)	14.9%	18.1%	13.0%	11.4%
EBITDA (LC)	4,047	4,881	5,262	5,739
EBITDA margin (%)	5.2%	5.3%	5.0%	4.9%
Tax rate (%)	19.5%	21.3%	20.5%	21.0%
Net profit (LC)	2,214	2,591	2,815	3,080
EPS (LC)	0.823	0.964	1.047	1.145
EPS growth (%)	7.8%	17.1%	8.7%	9.4%
DPS (LC)	0.3	0.3	0.3	0.4
BVPS (LC)	10.8	11.5	12.3	13.0
Operating cash flow (LC mn)	315	578	3,029	3,404
Free cash flow (LC mn)	(595)	(266)	2,262	2,497
Interest cover (x)	18.6	12.3	11.8	13.3
Net margin (%)	2.8%	2.8%	2.7%	2.6%
Sales/assets (X)	1.4	1.5	1.5	1.5
Debt/equity (%)	18.9%	23.5%	22.2%	21.0%
Net debt/equity (%)	-20.6%	-9.1%	-10.4%	-11.8%
ROE (%)	7.8%	8.6%	8.8%	9.1%
Key model assumptions	FY13	FY14A	FY15E	FY16E
Mfr. GM			47.8%	48.3%
Distribution GM			6.2%	6.2%
Effective tax rate			20.5%	21.0%

Source: Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA		EPS	
Sensitivity to	FY15E	FY16E	FY15E	FY16E
1% chg in drug sales vole growth	2.30%	2.20%	1.90%	2.00%
1ppt increase selling exp ratio	5.0%	8.1%	4.5%	7.2%
1ppt change in mfr. GM	0.5%	0.4%	0.8%	1.0%
1ppt change in distribution margin	20.0%	18.0%	18.0%	16.2%

Source: J.P. Morgan estimates.

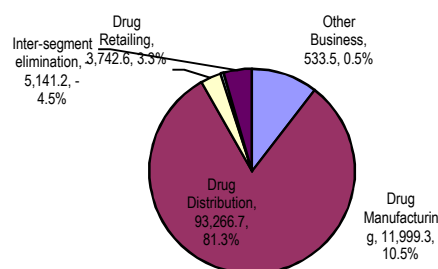
Comparative metrics	CMP LC	Mkt Cap \$Mn	P/E (x)		EV/EBITDA (x)		P/BV (x)		YTD Stock perf.
			FY14E	FY15E	FY14E	FY15E	FY14E	FY15E	
SHANGHAI PHARM-H (N)	23.95	11,387	18.0	16.1	16.3	14.9	1.7	12.2	36.9
SHANG PHARM -A (N)	29.10	11,386	26.8	23.3	15.9	13.8	2.6	12.3	76.4
FOSUN PHARMA-H (OW)	30.35	12,506	22.7	20.1	41.0	34.2	3.0	8.9	8.8
SHANGHAI FOSUN-A (N)	35.60	12,503	31.2	26.0	38.2	30.9	4.3	9.4	68.4
BAIYUNSHAN PH-H (NC)	30.25	8,983	23.9	20.0	30.3	25.6	2.9	9.4	29.0
GUANGZHOU BAIY-A (NC)	47.18	8,983	40.1	34.7	32.6	28.9	6.0	9.1	
SINOPHARM-H (OW)	36.95	13,188	22.7	18.5	11.0	9.3	2.6	12.8	34.6
JOINTOWN PHARM-A (NC)	32.95	8,724	86.7	72.4	50.1	39.3	6.5	5.4	82.3
NANJING PHARMA-A (NC)	19.01	2,749	71.7	49.4	29.1	23.2	7.2	3.0	164.4
CHINA SHINEWAY (NC)	12.58	1,342	11.1	10.9	6.3	6.0	1.6	6.8	9.0

Source: Bloomberg; Price as of 06/11/2015

Valuation and price target basis

Our Dec-15 price target of HK\$21.5 for the H-share is based on DCF analysis of our updated financial models.

Revenue mix (2015E)



Source: Company, J.P. Morgan estimates.

JPMe vs. consensus, change in estimates

EPS (LC)	FY15E	FY16E
JPMe old	1.069	1.068
JPMe new	1.047	1.145
% chg	-2.1%	7.2%
Consensus	1.067	1.193

Source: Bloomberg, J.P. Morgan estimates.

Model revisions

We are adjusting our models to reflect current expenses running ratios. Net/net, net profit estimates were revised up by -2.1% and +7.2% for 2015 and 2016, respectively.

Table 2: SPH - Model revisions

Year to Dec (Rmb 'mn)	New		Old		Change	
	FY15E	FY16E	FY15E	FY16E	FY15E	FY16E
Turnover	104,401	116,345	104,858	112,976	-0.4%	3.0%
Gross profit	12,709	13,889	13,059	13,838	-2.7%	0.4%
EBIT	3,827	4,146	3,712	3,658	3.1%	13.3%
Net profit	2,815	3,080	2,876	2,873	-2.1%	7.2%
EPS (Rmb)	1.05	1.15	1.07	1.07	-2.1%	7.2%
Gross margin	12.2%	11.9%	12.5%	12.2%	-0.28%	-0.31%

Source: Company data; Bloomberg

DCF valuation and Dec-15 PT of HK\$21.5

Our Dec-15 price target for the H share is based on our DCF analysis on our revised financial forecasts, which assumes a market premium of 6.0% and risk-free rate of 4.2% (yield on 10-year government notes in China). We assume a beta of 0.56 per Bloomberg. Accordingly, we assume a WACC of 9.7%, which contains a 2% premium as SPH is trading in a foreign stock exchange. We estimate free cash flow for SPH until 2017 and assume a terminal growth rate of 4.0%. The terminal growth is based on the annual growth rate expected in 2015 (the final year of the estimate period), subject to a minimum of 3% and a maximum of 6% depending on the nature of the industry and the level of maturity in China. We use 4% as we believe faster-growing distribution businesses will be balanced out by slower growth of SPH's manufacturing businesses.

Table 1: SPH - Base-case DCF analysis indicates an equity value per share of HK\$15

Rmb MM	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E
Cash flow estimates									
Sales	38,692	54,900	68,078	78,223	92,399	104,401	116,345	127,165	136,216
EBIT	2,481	3,289	3,280	3,443	4,196	4,534	4,934	5,359	5,606
NOPAT	1,977	2,648	2,583	2,737	3,315	3,560	3,848	5,359	5,606
Capex, net	(574)	(414)	(853)	(1,085)	(1,157)	(1,121)	(1,488)	(1,312)	(1,377)
Depreciation	437	513	582	604	685	727	806	886	963
Change in working capital	127	(989)	(1,108)	(1,190)	(1,262)	(1,317)	(1,367)	(1,409)	(1,443)
Free operating CF (FoCF)	1,966	1,759	1,204	1,066	1,582	1,849	1,800	3,524	3,749
DCF Parameters									
Liabilities as a % of EV		20%							
WACC		9.7%							
Enterprise NPV (10E-16E)									
+ Net cash (debt), current		8,348							
- Minorities (Market value)		(12,246)							
+/- Other items		0							
= Equity value		46,180							
/ Number of shares		2,689							
= Equity value per share (HK\$)		21.5							
Assumptions									
							4.0%		
							4.2%		
							6.0%		
							0.56		
							6.8%		
								15.9x	

Source: Company data, J.P. Morgan estimates.

Table 2: SPH - Sensitivity analysis based on WACC and perpetual terminal growth rate

		Terminal growth rate			
		3.5%	4.0%	4.5%	5.0%
WACC	9.0%	26.2	28.7	31.9	35.8
	9.5%	23.7	25.9	28.4	31.5
	10.0%	21.7	23.5	25.6	28.1
	10.5%	19.9	21.4	23.2	25.2
	11.0%	18.4	19.7	21.2	22.9
	11.5%	17.1	18.2	19.5	20.9
	12.0%	15.9	16.9	18.0	19.2

Source: Company data, J.P. Morgan estimates.

Investment Thesis, Valuation and Risks

Shanghai Pharmaceutical - H *(Neutral; Price Target: HK\$21.50)*

Investment Thesis

SPH is a leading manufacturer of various products, including chemical drugs/APIs, TCMS, biological drugs and medical devices. It is also China's second-largest distributor of drugs and medical products, and holds the largest market share in its home base of Shanghai. SPH was established through a merger of the original Shanghai Pharma, mostly a drug distributor, with two A-share listed manufacturers, Shanghai Industrial Pharmaceutical Investment and Zhongxi Pharmaceutical in 2009. SPH seeks to extract synergies between its distribution and drug manufacturing businesses.

Valuation

Our Dec-15 price target of HK\$21.5 for the H-share is based on DCF. We have conservatively applied a terminal growth rate of 4%, at the low end of the 3-6% growth rate we use for health care stocks. Our PT implies a 2016E P/E of 15.0x.

Risk free rate:	4.20%
Market risk premium:	6.00%
Beta:	1.00
WACC	9.7%
Terminal "g":	4.00%

Risks to Rating and Price Target

Key risks to our rating and PT are a slower pace of acquisition of new distributors and a faster pick-up in sales volume arising from the implementation of the Essential Drug List, resulting in low points taken by SPH because of low profitability to manufacturers who would ask for a shared sacrifice of profits from distributors. In addition, we see risks from: 1) an unexpected industry-wide slowdown; 2) acquisitions becoming prohibitively expensive; and 3) further deterioration of the manufacturing businesses.

Shanghai Pharmaceutical - H: Summary of Financials

Income Statement						Cash flow statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	78,223	92,399	104,401	116,345		- EBIT	3,443	4,196	4,534	4,934	-
% change Y/Y	14.9%	18.1%	13.0%	11.4%		- Depr. & amortization	604	685	727	806	-
Gross Profit	10,037	11,176	12,709	13,889		- Change in working capital	(1,190)	(1,262)	(1,317)	(1,367)	-
% change Y/Y	10.3%	11.3%	13.7%	9.3%		- Taxes	0	0	0	0	-
EBITDA	4,047	4,881	5,262	5,739		- Cash flow from operations	315	578	3,029	3,404	-
% change Y/Y	4.8%	20.6%	7.8%	9.1%		-					-
EBIT	3,443	4,196	4,534	4,934		- Capex	(1,085)	(1,157)	(1,121)	(1,249)	-
% change Y/Y	5.0%	21.9%	8.1%	8.8%		- Net Interest	(218)	(396)	(445)	(433)	-
EBIT Margin	4.4%	4.5%	4.3%	4.2%		- Other	1,387	1,358	0	0	-
Net Interest	(218)	(396)	(445)	(433)		- Free cash flow	(595)	(266)	2,262	2,497	-
Earnings before tax	3,226	3,800	4,089	4,501		-					-
% change Y/Y	4.5%	17.8%	7.6%	10.1%		- Equity raised/(repaid)	0	0	0	0	-
Tax	(628)	(808)	(838)	(945)		- Debt raised/(repaid)	1,091	807	57	60	-
as % of EBT	19.5%	21.3%	20.5%	21.0%		- Other	(529)	(179)	0	0	-
Net income (reported)	2,214	2,591	2,815	3,080		- Dividends paid	(874)	(1,024)	(1,102)	(1,213)	-
% change Y/Y	7.8%	17.1%	8.7%	9.4%		- Beginning cash	13,301	12,645	11,190	11,826	-
Shares outstanding	2,689	2,689	2,689	2,689		- Ending cash	12,645	11,190	11,826	12,590	-
EPS (reported)	0.82	0.96	1.05	1.15		- DPS	0.26	0.29	0.33	0.36	-
% change Y/Y	7.8%	17.1%	8.7%	9.4%		-					-
Balance sheet						Ratio Analysis					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	12,645	11,190	11,826	12,590		- Gross margin	12.8%	12.1%	12.2%	11.9%	-
Accounts receivable	18,540	23,951	27,062	30,158		- EBITDA margin	5.2%	5.3%	5.0%	4.9%	-
Inventories	10,997	13,088	14,125	16,201		- Operating margin	4.4%	4.5%	4.3%	4.2%	-
Others	333	418	2,923	2,437		- Net margin	2.8%	2.8%	2.7%	2.6%	-
Current assets	42,515	48,648	55,936	61,387		-					-
						- Sales per share growth	14.9%	18.1%	13.0%	11.4%	-
LT investments	2,699	4,540	4,767	5,005		- Sales growth	14.9%	18.1%	13.0%	11.4%	-
Net fixed assets	5,017	5,198	5,744	6,357		- Net profit growth	7.8%	17.1%	8.7%	9.4%	-
Total Assets	59,359	67,555	75,516	81,649		- EPS growth	7.8%	17.1%	8.7%	9.4%	-
Liabilities						- Interest coverage (x)	18.6	12.3	11.8	13.3	-
Short-term loans	5,924	7,953	7,892	7,892		-					-
Payables	19,572	23,701	26,780	29,844		- Net debt to equity	(20.6%)	(9.1%)	(10.4%)	(11.8%)	-
Others	203	348	3,247	4,147		- Working Capital to Sales	0.2	0.2	0.2	0.2	-
Total current liabilities	25,699	32,003	37,918	41,883		- Sales/assets	1.4	1.5	1.5	1.5	-
Long-term debt	125	105	167	167		- Assets/equity	2.0	2.1	2.2	2.3	2.3
Other liabilities	1,486	1,133	1,190	1,250		- ROE	7.8%	8.6%	8.8%	9.1%	-
Total Liabilities	27,311	33,241	39,275	43,299		- ROCE	8.2%	8.9%	9.0%	9.3%	-
Shareholders' equity	32,048	34,314	36,241	38,350		-					-
BVPS	10.79	11.54	12.26	13.04		-					-

Source: Company reports and J.P. Morgan estimates.

JPM Q-Profile

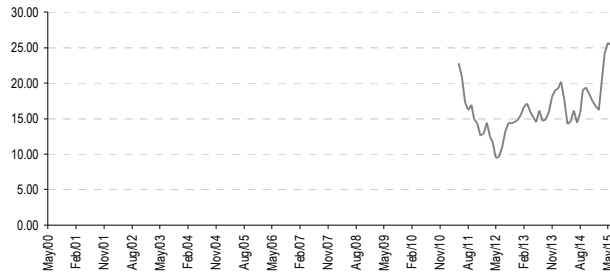
Shanghai Pharmaceuticals Holding Co. Ltd. Class H (CHINA / Health Care)
As Of: 03-Jun-2015

Global Equity Quantitative Analysis

Quant_Strategy@jpmorgan.com

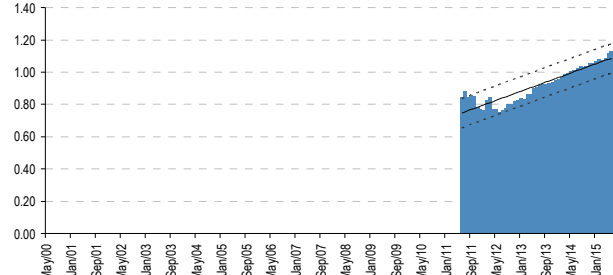
Local Share Price

Current: 25.30



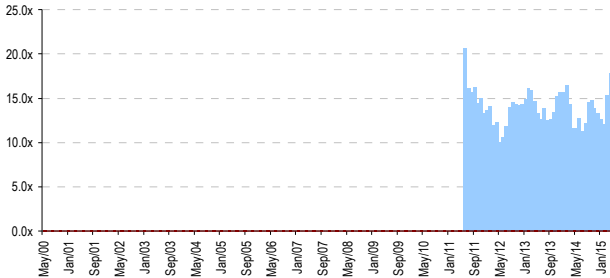
12 Mth Forward EPS

Current: 1.13



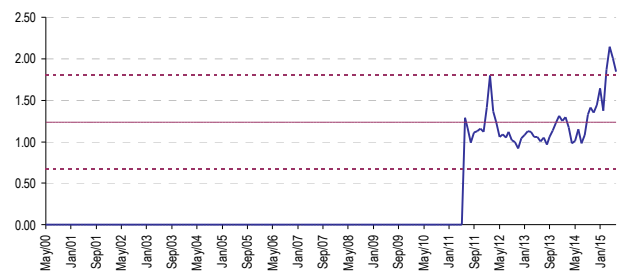
PE (1Yr Forward)

Current: 17.8x



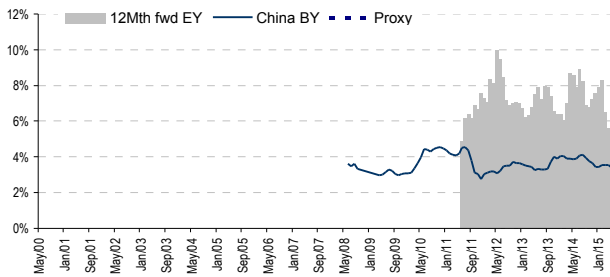
P/E Relative to China Index

Current: 1.84



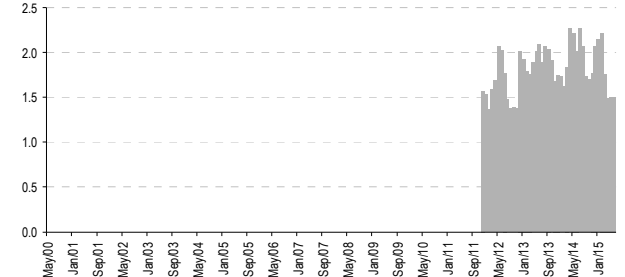
Earnings Yield (& Local Bond Yield)

Current: 6%



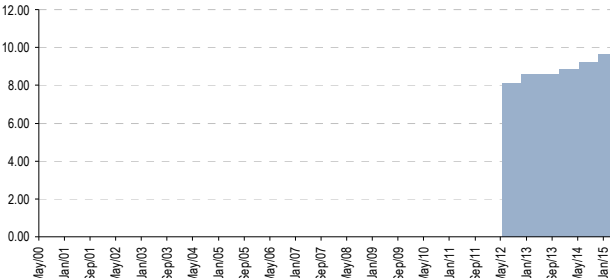
Dividend Yield (Trailing)

Current: 1.50



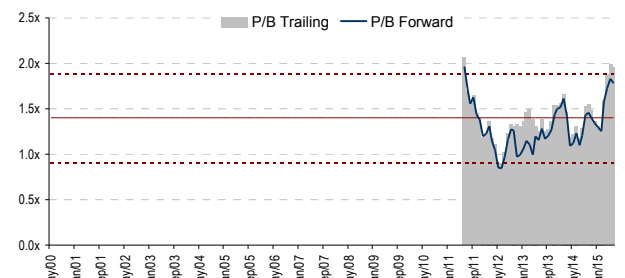
ROE (Trailing)

Current: 9.64



Price/Book (Value)

Current: 2.0x



Summary

Shanghai Pharmaceuticals Holding Co. L				As Of: 3-Jun-15							
CHINA		TICKER 2607 HK		Local Price: 25.30							
Health Care				EPS: 1.13							
	Latest	Min	Max	Median	Average	2 S.D.+	2 S.D. -	% to Min	% to Max	% to Med	% to Avg
12mth Forward PE	17.81x				1.40	1.89	0.91	-54%	5%	-31%	-29%
P/BV (Trailing)	1.95	0.90	2.06	1.36	1.81	2.34	1.29	-9%	51%	18%	21%
Dividend Yield (Trailing)	1.50x	1.37	2.27	1.78	8.86	9.87	7.86	-16%	0%	-8%	-8%
ROE (Trailing)	9.64	8.12	9.64	8.87							

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

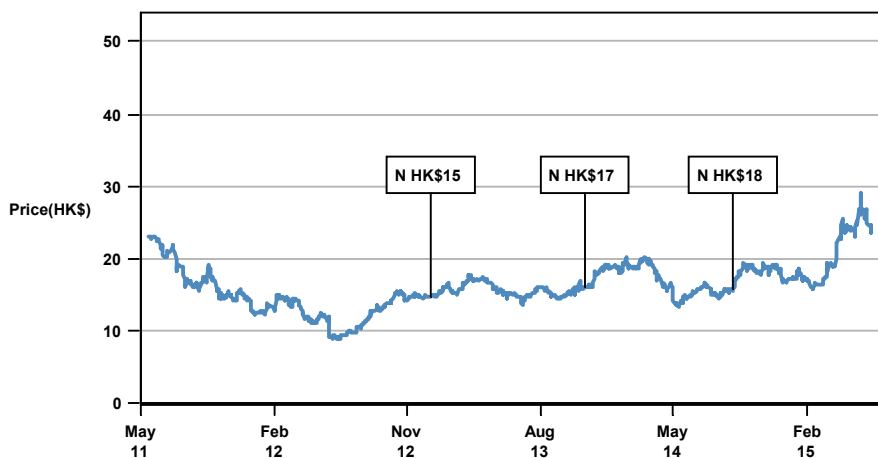
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- **Client:** J.P. Morgan currently has, or had within the past 12 months, the following company(ies) as clients: Shanghai Pharmaceutical - H.

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Shanghai Pharmaceutical - H (2607.HK, 2607 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
18-Dec-12	N	14.54	15.00
29-Oct-13	N	16.04	17.00
31-Aug-14	N	15.90	18.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Dec 18, 2012.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.

J.P. Morgan ratings or designations: OW = Overweight, N= Neutral, UW = Underweight, NR = Not Rated

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Coverage Universe: Wu, Sean: CSPC Pharmaceutical (1093.HK), China Medical System (0867.HK), Fosun Pharmaceutical - A (600196.SS), Fosun Pharmaceutical - H (2196.HK), Jiangsu Hengrui Medicine - A (600276.SS), Lijun Intl Pharmaceutical (2005.HK), MicroPort Scientific Corp (0853.HK), Mindray Medical (MR), Seegene, Inc. (096530.KQ), Shandong Weigao Group Medical Polymer Co. Ltd. (1066.HK), Shanghai Pharmaceutical - A (601607.CH), Shanghai Pharmaceutical - H (2607.HK), Sihuan Pharmaceutical Holdings (0460.HK), Sino Biopharmaceutical (1177.HK), Sinopharm (1099.HK)

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J.P. Morgan Global Equity Research Coverage	43%	44%	13%
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